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TAGS: ECON EFIN EINV EPET MY
SUBJECT: Malaysia: 2010 Budget Calls for Big Spending Cuts

¶1. (SBU) SUMMARY: Prime Minister Najib unveiled Malaysia's 2010 budget on October 23. The GOM aims to achieve a dramatic reduction in its budget deficit from an expected 7.4 percent of GDP in 2009 to 5.6 percent of GDP in 2010. The GOM projects lower revenues due to reduced 2009 profits in their oil and gas industry and plans to address this by significantly reducing spending in key areas. The forecast 13.7 percent reduction in operating expenses and 4.5 percent decline in development spending results in a 11.4 percent spending cut. The operating budget includes significant reductions in fuel subsidy costs and a huge reduction in the cost of supplies and miscellaneous items under the "other expenses" category. Najib announced several new tax measures, most having limited impact on the budget except for a tax system change to increase current year revenues from upstream oil producers that impacts national oil company Petronas and their foreign oil and gas company partners. Najib also hinted that the GOM will introduce a general sales tax (GST), but gave limited details. The GOM used conservative assumptions to form the budget including improving their forecast for 2009 from a 5 percent contraction to a 3 percent contraction, projecting 2-3 percent GDP growth for 2010, and assuming oil prices remain at $70 per barrel. Najib also signaled the GOM is reviewing acceleration of non-core assets sales in government linked corporations and announced numerous incentive programs for development in targeted industries. END SUMMARY.

¶2. (SBU) COMMENT: The 2010 budget is Prime Minister Najib's first since he came to power. The general consensus among our banking and finance contacts is that this budget is a responsible effort to reduce Malaysia's growing deficit by cutting bloated operating expenses, which had increased 30% since 2007. The budget is seen as neutral for most U.S. firms, though the new tax on credit cards will hit Citibank, along with other major credit card issuers. Our contacts also do not see the spending cuts as contractionary due to significant stimulus spending accounted for in 2009 will not actually be paid out until 2010. However, the GOM's overreliance on oil and gas revenues to support government spending is coming back to bite it. The GOM plans to achieve deficit reduction by ensuring spending cuts outpace revenue declines. To achieve the 2010 budgeted cuts, the Najib Administration is committing to long overdue but politically difficult reforms in government procurement procedures and fuel subsidies programs. There is significant local skepticism that Najib has the political will push through these changes. The restructuring of the upstream oil and gas income tax system means current year tax revenues will be highly dependent on the price of oil, increasing revenue volatility and giving the Ministry of Finance (MOF) minimal time to react if oil prices dive. Prime Minister Najib is calculating that the recovery is real, oil prices will stay above their $70 per barrel target, and he can get the announced reforms passed by Parliament. If he is correct, the GOM will likely meet or outperform a 5.4 percent of GDP deficit,

otherwise the deficit could surpass 2009 levels, potentially causing increased economic hardship. END COMMENT.

Malaysian 2010 Budget - Focus on Spending Cuts
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¶3. (SBU) Malaysia announced its 2010 budget on October 23 trying to strike a balance between enhancing fiscal sustainability and providing support to the economy. The government improved its projection for the 2010 fiscal deficit from a revised 2009 figure of 7.4 percent of GDP (USD 14.9 billion at MYR3.42 per USD 1) to 5.4 percent of GDP (USD 11.8 billion). The GOM proposed to achieve the reduction by cutting 13.7 percent from its operating expenditures, as well as a 4.5 percent from development expenditures. The operating expense cuts are focused on: reducing fuel subsidies by 14.7 percent (USD 1.2 billion) and targeting the remaining subsidies to the poor; implementing a competitive bidding process in government procurement to reduce spending on supplies by 22.2 percent (USD 1.8 billion); and curtailing discretionary expenditures by trimming "other expenditure" 63.7 percent (USD 5.4 billion) over 2009 levels. Few details were given on implementation of a more targeted fuel subsidy system apart from that it would target the poor and utilize the MyKad smart-card system and existing infrastructure. The Prime Minister suggested the politically sensitive ethnic Malay-biased government procurement system would be reformed to allow competitive bidding. The "other expenditure" category is buried in the footnotes of the Economic Report released along with the budget and includes "grants to Statutory Funds, public enterprises, international organizations, insurance claims and gratuities and others". There was a large increase in this expense category in 2009 and expenditure was budgeted to return to near 2008 levels in 2010.

Revenues Slump on Lower Oil and Gas Proceeds

¶4. (SBU) The GOM projects 2010 total revenues to fall 8.4 percent, with reduced income from oil and gas causing the decline. 2010 Income tax receipts attributable to oil and gas were forecasted to fall 28.3 percent from USD 7.9 billion in 2009 to USD 5.7 billion. In addition, the GOM forecast and additional USD 3.4 billion lower 2010 non-tax revenues, due to declining Malaysian oil and gas production, in the form of lower dividends from Petronas and other government linked corporations (GLCs) as well as lower licensing fees paid by foreign oil producers. Petronas provided 41 percent of 2009 GOM revenues, which will decline to 38 percent in 2010.

¶5. (SBU) In order to avoid an additional USD 1.2 billion reduction in oil and gas income tax revenue, the income tax system for upstream oil and gas was changed from a preceding year assessment system to a current year assessment system. This should boost GOM 2010 tax revenue from oil companies whose 2009 profits slumped due to the dramatic fall in oil and gas prices. Companies will pay 2010 taxes based on 2010 estimated profits plus their 2009 taxes due in increments over a 5-year period, effectively increasing their current tax liabilities by 20%. The tax system restructure affects Petronas and international oil companies' upstream operations producing in Malaysia. U.S. oil and gas companies are unhappy about the unexpected tax hike, according to Exxon Mobil's Director of Business Services. Exxon Mobil and Murphy Oil are significant producers in 2009 and are still working with Petronas to determine the extent of the tax increase over previous 2010 projections. The foreign oil companies were not forewarned of an impending change in their tax system. Conoco Philips Malaysia President told us that the restructure will not impact Conoco's 2010 taxes as they are not scheduled to begin production in Sabah until 2011.

New Tax Increases Offset by New Tax Cuts

¶6. (SBU) Given the decline in Petronas-based revenues, many observers were surprised by a second straight 1 percentage point reduction in the top rate of personal income tax to 26 percent and increased exempted annual income from USD 2,339 to USD 2,631. To

offset the personal income tax decrease, the government proposed a 5 percent capital gains tax on investment property sales. The GOM spun the tax increase as a targeted measure to prevent future property asset bubbles. The GOM also proposed a USD 15 annual tax on credit cards and a USD 2,932 fee on automobile import permits. Citibank is Malaysia's top credit card issuer and told us that the new tax on credit cards will significantly damage their credit card business in Malaysia. Citi dominates the co-branded credit card business that offers large discounts at co-branded stores to users. Many Citi cardholders have multiple Citi co-branded cards, which carry no annual fee, and Citi is concerned that the USD 15 annual tax per card will drive consumers to consolidate their cards, actually costing consumers the benefit of the discounts they are now enjoying. Citi has reached out to the MOF to negotiate one fee per customer per bank rather than per card. The net effect of the new tax measures on the 2010 budget is negligible.

PM Floats GST Trail Balloon

¶7. (SBU) Prime Minister Najib announced the GOM is in the final stages of completing a study on GST implementation. Najib noted that if the GST were to be implemented, it would replace the current tax on services at a lower rate. There would also be exemptions granted to lower income groups. GST implementation would broaden the revenue base away from petroleum and likely be revenue neutral in the near term, with benefits felt more in the medium term if GST rates were increased.

GOM Asset Divestiture Announced

¶8. (SBU) The GOM also proclaimed it will reduce its involvement in economic activities and accelerate divestiture of non-core government linked companies (GLCs) and other assets owned by Ministry of Finance and other agencies, which could augment 2010 revenues. The finance ministry announced it will conduct a sweeping review of barriers to investment, and plans to attract foreign investors to take up stakes in non-core state owned companies. The August 2009 announcement by Petronas that it will continue to

explore the possibility of publicly listing its core gas and marketing subsidiaries is in line with the GOM considering strategic divestments. Since July 2009, the GOM sold small stakes in Malaysia Airports Holdings, Plus Expressways and Pos Malaysia (the national postal company). There have been increasing press reports of investor interest in such companies as Astro All Asia Networks, Axiata Group, Plus Expressways and Sime Darby palm oil plantation company. There are also recent reports the government is marketing valuable land holdings in the Kuala Lumpur area. Bank analysts estimate a USD 25-30 billion market value for GOM non-core assets.

Growth Incentives Highlighted

¶9. (SBU) Prime Minister Najib also announced a variety of incentive measures to stimulate growth and assist Malaysia move up the development ladder towards a high-income economy. Funds were allocated to helping small and medium-sized enterprises and to strategically important sectors like agriculture and construction. In addition, funds were earmarked for infrastructure development, to improve Malaysia's transport networks and production capacity and boost Malaysian long-term competitiveness. Further financial sector liberalization measures include allowing 100 percent foreign ownership of financial planning and corporate finance firms, with a clear emphasis on Islamic finance to further cement Malaysia's position in this niche market. U.S. banks operating in Malaysia commented that they expect the financial sector liberalization measures will have minimal impact on bringing in new financial sector investment. Funds were also allocated to strengthen existing social-safety-net programs and promote greater awareness and implementation of green technology.

2009 GDP Outlook Upgraded, 2010 Growth Modest

¶10. (SBU) The Ministry of Finance upwardly revised its 2009 and 2010 GDP forecasts. It revised its 2009 GDP projection from a contraction of 4-5 percent to a contraction of 3.0 percent provided a cautious GDP growth range of 2-3 percent for 2010. Continued buoyant construction activity and a resilient service sector led 2009 growth expanding 3.5 percent and 2.1 percent, respectively. In contrast, manufacturing was projected to decline 12.1 percent in 2009. All sectors are expected to register positive growth in 2010. The manufacturing sector, 26 percent of GDP, is expected to recover the most in absolute terms with 1.7 percent growth, while construction and services will rise 3.2 percent and 3.6 percent next year. The government expects inflation to remain low at 1.5-2.5 percent in
¶2010. The GOM 2010 GDP growth projections are well below our banking contacts projections, which range from 3.8 percent to 6.5 percent.

KEITH